

# Summary of OIG's Audit Report



## Inspector General's Report on EPA's Fiscal 2004 and 2003 Financial Statements

The Administrator  
U.S. Environmental Protection Agency

We have audited the consolidating balance sheets of the U.S. Environmental Protection Agency (EPA, or the Agency) and its subsidiary funds, the Superfund Trust Fund (Superfund), and All Other Appropriated Funds (All Other), as of September 30, 2004 and 2003, and the related consolidating statements of net cost, changes in net position and financing, and consolidated statements of net cost by goal, custodial activity, and combined statements of budgetary resources for the years then ended. These financial statements are the responsibility of EPA's management. Our responsibility is to express an opinion on these financial statements based upon our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial statements contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The financial statements include expenses of grantees, contractors, and other Federal agencies. Our audit work pertaining to these expenses included testing only within EPA. Audits of grants, contracts, and interagency agreements performed at a later date may disclose questioned costs



of an amount undeterminable at this time. In addition, the U.S. Treasury collects and accounts for excise taxes that are deposited into the Superfund and Leaking Underground Storage Tank Trust Funds.<sup>1</sup> The U.S. Treasury is also responsible for investing amounts not needed for current disbursements and transferring funds to EPA as authorized in legislation. Since the U.S. Treasury, and not EPA, is responsible for these activities, our audit work did not cover these activities.

As more fully described in Note 36 to the financial statements, the Superfund Trust Fund, managed by the U.S. Treasury Bureau of Public Debt, transferred funds to EPA in excess of the assets available to be transferred by \$7.6 million in fiscal 2004 and \$82.7 million in fiscal 2003. EPA's view is that the shortfalls will be covered by the collection of cost recoveries and receipt of interest income over time. In our opinion, because cost recoveries have declined and the investment principal upon which the interest is earned has steadily decreased, any deficit and future financing will have to be covered almost entirely by appropriations from the Treasury's general fund in order for the Superfund Trust Fund to continue operations.

The Office of Inspector General (OIG) is not independent with respect to amounts pertaining to OIG operations that are presented in the financial statements. The amounts included for the OIG are not material to EPA's financial statements. The OIG is organizationally independent with respect to all other assets of the Agency's activities.

In our opinion, the consolidating financial statements present fairly, in all material respects, the consolidated and individual assets, liabilities, net position, net cost, net cost by goal, changes in net position, budgetary resources, reconciliation of net cost to budgetary obligations, and custodial activity of EPA and its subsidiary funds, the Superfund Trust Fund, and All Other Appropriated Funds, as of and for the years ended September 30, 2004 and 2003, in conformity with accounting principles generally accepted in the United States of America.



#### REVIEW OF EPA'S REQUIRED SUPPLEMENTAL STEWARDSHIP INFORMATION, REQUIRED SUPPLEMENTAL INFORMATION, AND MANAGEMENT DISCUSSION AND ANALYSIS

We inquired of EPA's management as to their methods for preparing Required Supplemental Stewardship Information (RSSI), Required Supplemental Information, and Management Discussion and Analysis, and reviewed this information for consistency with the financial statements. However, our audit was not designed to express an opinion and, accordingly, we do not express an opinion.

We did not identify any material inconsistencies between the information presented in EPA's financial statements and the information presented in EPA's RSSI, Required Supplemental Information, and Management Discussion and Analysis. OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, requires agencies to report, as Required Supplemental Information, their intra-governmental assets and liabilities by Federal trading partner. We did find EPA continues to experience difficulties in reconciling some of its intragovernmental transactions due to some Federal entities not providing information for reconciliations (see Attachment 2 for additional details on this issue).

<sup>1</sup> The Leaking Underground Storage Tank Trust Fund is included in the All Other Appropriated Funds column of the financial statements.

## EVALUATION OF INTERNAL CONTROLS

As defined by OMB, internal control, as it relates to the financial statements, is a process, affected by the Agency's management and other personnel, designed to provide reasonable assurance that the following objectives are met:

**Reliability of financial reporting**—Transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and RSSI in accordance with generally accepted accounting principles; and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

**Reliability of performance reporting**—Transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.



**Compliance with applicable laws and regulations**—Transactions are executed in accordance with laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements or RSSI; and any other laws, regulations, and government-wide policies identified by OMB.

In planning and performing our audit, we considered EPA's internal controls over financial reporting by obtaining an understanding of the Agency's internal controls, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as supplemented by an OMB memorandum dated January 4, 2001, *Revised Implementation Guidance for the Federal Financial Management Improvement Act*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal controls and, accordingly, we do not express an opinion on internal controls.

Our consideration of the internal controls over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the Agency's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We noted certain matters discussed below involving the

internal control and its operation that we consider to be reportable conditions, although none of the reportable conditions is believed to be a material weakness.

In addition, we considered EPA's internal control over the RSSI by obtaining an understanding of the Agency's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on these internal controls and, accordingly, we do not express an opinion on such controls.

Finally, with respect to internal controls related to performance measures presented in EPA's *Fiscal Year 2004 Annual Report*, Section 1, Overview and Analysis (which addresses requirements for a Management's Discussion and Analysis), we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not express an opinion on such controls.

## REPORTABLE CONDITIONS

Reportable conditions are internal control weakness matters coming to the auditor's attention that, in the auditor's judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control that could adversely affect the organization's ability to meet the OMB objectives for financial reporting discussed above. In evaluating the Agency's internal control structure, we identified 10 reportable conditions, as follows:

### *Financial Management Quality Assurance Process*

EPA's Quality Assurance Guide, which is the framework for implementing the Agency's financial management quality assurance program, is out of date. EPA offices did not consistently review all required accounting events identified in the guide, and those reviews conducted were not sufficiently comprehensive. Financial Centers placed minimal emphasis on financial system functional reviews to support Federal Managers' Financial Integrity Act (FMFIA) certifications, and EPA has no central oversight of the Quality Assurance program. As a result, the program's effectiveness was minimized.

### *Unearned Revenue and Superfund Unbilled Oversight Cost Accruals*

Although EPA made financial improvements in fiscal 2004 by reconciling State Superfund Contracts' unearned revenue and implementing accelerated unbilled oversight cost accrual procedures, errors continued to occur in regional spreadsheet calculations. Regional calculations did not include the proper amounts of cumulative disbursements, resulting in a \$14 million understatement of unearned revenue. Regional billed oversight calculations did not follow all the new accrual procedures, resulting in a \$3 million understatement of the accrual, and the prior year's unbilled oversight accrual was overstated by \$10 million due to prior year errors.





### *Supporting Documentation for Accounts Receivable*

Finance offices were unable to record accounts receivable transactions promptly in the Integrated Financial Management System (IFMS) due to the Office of General/Regional Counsel and program offices not submitting documentation in a timely manner. Finance offices received documentation supporting the establishment of receivables up to 6 months after the agreements were executed. Further, we identified \$1,963,980 in fines and penalties that were unrecorded at the time of our audit. We noted numerous instances in which the finance offices requested support for previously unrecorded accounts receivable only after collected.



### *Recording of Marketable Securities*

EPA did not promptly record marketable securities received from companies in settlement of debts. During fiscal 2004, the Agency received securities from three companies for settlement of debts under receivables recorded at four accounting offices. Of the four accounting offices, only one recorded receipt of non-cash assets. The accounting offices that did not record the receipt of non-cash assets either were not aware that marketable securities were received or stated that they were awaiting additional information from Headquarters.

### *Accounting for Contractor-Held Property*

Contractor-held property acquisition values were understated by about \$6.9 million. When we attempted to tie the ending balances as shown on all the EPA Reports of Government-Owned/Contractor-Held Property documents to the September 30, 2004 general ledger balance for contractor-held property, we discovered that contractor-held balances did not include a \$6,883,574 contract. Also, the Agency improperly accounted for surplus contractor-held property in depreciation computations.

### *Accounting for Obligations*

Obligations were not recorded in the proper accounting period. In one region and a finance center, we found 10 out of 16 obligations tested were recorded in fiscal 2005 but were actually fiscal 2004 obligations. Also, for one of the obligation transactions tested, involving an adjustment, the finance center had no supporting documentation. Further, in one region, four out of seven inactive unliquidated obligations were not deobligated in a timely manner.

### *Systems Development for Grant and Inter-Governmental Systems*

The Operations Systems Staff of the Office of the Chief Financial Officer (OCFO) developed and implemented accounting systems without assessing the risks these systems pose to Agency assets, personnel, and operations. The staff also did not produce key documents for the Grant Payment Allocation System and Inter-Governmental Document Online Tracking System because they did not deem these systems to be major applications. However, since both systems are used to submit information into IFMS, EPA's main financial accounting system, we consider these systems to be major applications.



### *System Certification and Accreditation for Grant and Inter-Governmental Systems*

OCFO's Operations Systems Staff did not ensure management controls were operating effectively by assessing and testing security controls for the Grant Payment Allocation System and Inter-Governmental Document Online Tracking System. Specifically the staff's policies and procedures could not provide reasonable assurance that applications achieved their intended results; resources were protected from fraud, waste, and abuse; and applications followed applicable Agency policies and Federal guidelines. Also, we found four "high risk" security holes on a critical server hosting eight financial applications.

### *IFMS Change Control Procedures*

In an August 24, 2004, audit report, *EPA Needs to Improve Change Controls for Integrated Financial Management System* (2004-P-00026), we reported a general breakdown of security controls related to software changes that could undermine the integrity of IFMS software libraries and financial system data. Weaknesses included inadequate segregation of change management duties, and inappropriate ID use. In response to the recommendations in our prior report, OCFO concurred with our recommendations and generally outlined appropriate corrective actions.

### *IFMS Automated Application Processing Controls*

We continue to be unable to assess the adequacy of the automated application control structure as it relates to automated input, processing, and output controls for IFMS. Since IFMS applications have a direct and material impact on the Agency's financial statements, assessing each application is necessary to determine the reliance we can place on the financial statements. During past financial statement audits, we attempted to evaluate controls without systems documentation, but these alternatives proved to be inefficient and impractical. OCFO has no plans to update the IFMS system documentation until it implements the new financial replacement software package, currently projected for fiscal 2008. Until the new system is in place, we cannot assess the adequacy of the automated internal control structure.

Attachment 1 describes each of the above reportable conditions in more detail, and contains our recommendations on actions that should be taken to correct these conditions. We have also reported other less significant matters involving the internal control structure and its operations in separate position papers during the course of our audit. We will not be issuing a separate management letter.

### **COMPARISON OF EPA'S FMFIA REPORT WITH OUR EVALUATION OF INTERNAL CONTROLS**

OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, requires us to compare material weaknesses disclosed during the audit with those material weaknesses reported in the Agency's FMFIA report that relate to the financial statements and identify material weaknesses disclosed by audit that were not reported in the Agency's FMFIA report. EPA reports on Integrity Act decisions in EPA's *Fiscal Year 2004 Annual Report*. For a discussion on

Agency reported Integrity Act material weaknesses and corrective action strategy, please refer to EPA's *Fiscal Year 2004 Annual Report*, Section I—Overview and Analysis.

For reporting under FMFIA, material weaknesses are defined differently than they are for financial statement audit purposes. OMB Circular A-123, *Management Accountability and Control*, defines a material weakness as a deficiency that the Agency head determines to be significant enough to be reported outside the Agency.

For financial statement audit purposes, OMB defines material weaknesses in internal control as reportable conditions in which the design or operation of the internal control does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material in relation to the financial statements or RSSI being audited, or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

The Agency did not report as part of the Integrity Act process, and our audit did not detect, any material weaknesses for fiscal 2004.



### TESTS OF COMPLIANCE WITH LAWS AND REGULATIONS

EPA management is responsible for complying with laws and regulations applicable to the Agency. As part of obtaining reasonable assurance about whether the Agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as supplemented by an OMB Memorandum dated January 4, 2001, *Revised Implementation Guidance for the Federal Financial Management Improvement Act*. The OMB guidance requires that we evaluate compliance with Federal financial management system requirements, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to EPA.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion. There are a number of ongoing investigations involving EPA's grantees and contractors that could disclose violations of laws and regulations, but a determination about these cases has not been made. In

addition, the Agency reported that the approximately 9,000 confidential financial disclosure forms filed by EPA employees by November 1, 2004, will be reviewed by the deputy ethics officials no later than January 22, 2005. Since the Agency has not had time to review such reports and disclose matters that would require further inquiry, resolution, or reporting, we did not perform any tests or additional inquiries about those reports. Had the Agency been able to review the reports and we had been able to perform tests or make





additional inquiries, matters may have come to our attention that would require reporting.

None of the noncompliances discussed below would result in material misstatements to the audited financial statements.

### FFMIA NONCOMPLIANCE



Under FFMIA, we are required to report whether the Agency's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. OMB Bulletin No. 01-02, as supplemented by an OMB memorandum dated January 4, 2001, *Revised Implementation Guidance for the Federal Financial Management Improvement Act*, substantially changed the guidance for determining whether or not an Agency substantially complied with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. The document is intended to focus Agency and auditor activities on the essential requirements of FFMIA. The document lists the specific requirements of FFMIA, as well as factors to consider in reviewing systems and for determining substantial compliance with FFMIA. It also provides guidance to Agency heads for developing corrective action plans to bring an Agency into compliance with FFMIA. To meet the FFMIA requirement, we performed tests of compliance with FFMIA section 803(a)

requirements and used the OMB guidance, revised on January 4, 2001, for determining substantial noncompliance with FFMIA.

The results of our tests did not disclose any instances where the Agency's financial management systems did not substantially comply with the applicable Federal accounting standard.

We recognize improvements OCFO has made in cost accounting and believe that while there are still noncompliance issues with cost accounting, those noncompliances do not meet OMB's definition of substantial noncompliance. However, the Agency was not in compliance with Statement of Federal Financial Accounting Standards No. 4 that requires EPA to provide full costs per output to management in a timely fashion.

We identified two other FFMIA noncompliances, related to reconciliation of intragovernmental transactions and strengthening practices regarding security screening for non-Federal personnel. However, these noncompliances do not meet the definition of substantial noncompliance as described in OMB guidance.

Our tests also noted one other instance of noncompliance with laws and regulations, related to the Treasury Financial Manual for preparation of Statement of Transactions.





Subsequent to the completion of our audit work, the Agency took action to implement Treasury procedures for preparation of Statement of Transactions.

Attachment 2 provides additional details, as well as our recommendations on actions that should be taken on these matters. We have also reported other less significant matters involving compliance with laws and regulations in position papers during the course of our audit. We will not be issuing a separate management letter.

### PRIOR AUDIT COVERAGE

During previous financial or financial-related audits, weaknesses that impacted our audit objectives were reported in the following areas:

- Reconciling and reporting intra-governmental transactions, assets, and liabilities by Federal trading partner.
- Complying with Statement of Federal Financial Accounting Standards No. 4, including accounting for the cost to achieve goals and identifying and allocating indirect costs.
- Interagency Agreement invoice approval process.
- Documenting EPA's IFMS.
- Complying with Federal financial management system security requirements.
- Preparation and reconciliation of Statement of Transactions.
- Documentation and approval of journal vouchers.
- Assessing automated application processing controls for IFMS.
- Reconciling Unearned Revenue for State Superfund Contracts.
- Managing EPA's Accounts Receivable.



Attachment 3, Status of Prior Audit Report Recommendations, summarizes the current status of corrective actions taken on prior audit report recommendations with corrective actions in process.

The Chief Financial Officer, as the Agency's Audit Followup Official, oversees EPA's followup on audit findings and recommendations, including resolution and implementation of corrective actions. For these prior audits, final action occurs when the Agency completes implementation of the corrective actions to remedy weaknesses identified in the audit.

We acknowledge that many actions and initiatives have been taken to resolve prior financial statement audit issues. We also recognize that the issues we have reported are complex, and require extensive, long-term corrective actions and coordination by the Chief Financial Officer with various Assistant Administrators, Regional Administrators, and Office Directors before they can be completely resolved. A few issues have been unresolved for many years. The OIG will continue to work with the OCFO in helping to resolve all audit issues resulting from our financial statement audits.

### AGENCY COMMENTS AND OIG EVALUATION

In a memorandum dated November 12, 2004, OCFO responded to our draft report.

The rationale for our conclusions and a summary of the Agency comments are included in the appropriate sections of this report, and the Agency's complete response is included as Appendix II to the OIG's complete audit report.

This report is intended solely for the information and use of the management of EPA, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.



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Office of Inspector General  
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